

Welcome

# Lease Accounting

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# Agenda

- Basic concepts
- Lessee accounting
- Lessor accounting
- Challenges
- Disclosures and transition
- Future timeframes



# BASIC CONCEPTS



# Definition and Scope

- Lease is a contract in which the right to use a specified asset is given, for a period of time, in exchange for consideration.
- Applies to all leases (including subleases) except:
  - Leases of intangible assets
  - Leases to explore for natural resources
  - Leases of biological assets



# Definition and Scope

- Leases must be broken into separate lease and service components.
  - Example – Lease of office space that includes provision of separate services for collocation of IT equipment and maintenance
  - If service component is distinct, separate the contract into its components
  - Otherwise all are factored into the lease component



# Definition and Scope

- Short cut method for short term (less than 12 months) leases
- Includes
  - Long term leases of land
  - Leases of non core assets



# LESSEE ACCOUNTING



# Lessee Accounting

- Lease signing
  - Balance sheet
    - Recognize a right of use asset (includes lease liability plus any direct costs incurred)
    - Recognize lease liability
      - Calculated as the present value of lease payments
      - Discounted using lessee's incremental borrowing rate
  - Income statement
    - No impact
  - Net impact – All leases are capital leases!



# Lessee Accounting

- Monthly during lease term
  - Amortize right of use asset on straight line basis
  - Allocate lease payments to lease liability and interest based upon amortization schedule



# Lessee Accounting - Reassessment

- Only required if facts and circumstances indicate there may be a significant change
- Example – Management changes their expectation on renewal options



# LESSOR ACCOUNTING



# Lessor Accounting

- Does the lessor retain significant risks or benefits of the asset during or after the lease term?
  - Building lease – yes
  - Equipment lease - ??
- Answer – No – Use Derecognition approach
- Answer – Yes – Use Performance obligation approach



# Lessor Accounting – Derecognition

- Lease signing
  - Balance sheet
    - Derecognize the leased asset (leaving residual value)
    - Record lease receivable
      - Calculated as present value of lease payments
      - Plus any direct costs incurred
  - Income statement
    - Income – Present value of lease payments
    - Cost – Derecognized cost of asset
- Net impact – Sale of asset



# Lessor Accounting - Derecognition

- Monthly during lease term
  - Collect payments
    - Reduces lease payment receivable
    - Realize interest income based upon discount rate

# Lessor Accounting – Performance Obligation

- Lease signing
  - Balance sheet
    - Record lease receivable
      - Calculated as present value of lease payments
      - Plus any direct costs incurred
    - Record lease liability
      - Calculated as present value of lease payments
    - No change to asset being leased
  - Income statement – No impact
  - Net impact – Grosses up balance sheet

# Lessor Accounting – Performance Obligation

- Monthly during lease term
  - Collect payments
    - Reduce lease payment receivable
    - Recognize interest income
  - Lease liability
    - Reduce liability on straight line basis to recognize income
  - Leased asset
    - Depreciated



# Lessor Accounting - Reassessment

- Only required if facts and circumstances indicate there may be a significant change
- Example – Management changes their expectation on renewal options
- Identical to Lessee accounting reassessment



# CHALLENGES



# Difficult Concepts

- Determining lease term
  - Must factor renewal options into the term
- Determining lessee incremental borrowing rate
  - If it isn't defined in the lease, how to determine?
- Contingent rentals, penalties and residual value guarantees



# Renewal Options

- Lease term must be the *longest possible* lease term that is *more likely than not* to occur
- Example
  - An entity has a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years and an option to renew for an additional 5 years at the end of 15 years. Assume that the entity determines the probability for each term as follows:



# Renewal Example

Lease Term	Probability	Cumulative probability
10 years	45%	100%
15 years	15%	55%
20 years	40%	40%



There is a 55 percent chance that the term will be 15 years, which is the longest possible term more likely than not to occur. Therefore, the lease term is 15 years



# Lessee Incremental Borrowing Rate

- Key component in discounting lease payments
- Many leases do NOT specify this
  - Exception – Leases that are capital leases under today's definition
- Without this rate being defined – how do you determine it?



# Contingent Rent Example

- Company enters into an arrangement to lease a retail location.
- 15-yr non-cancellable lease with no renewal options.
- Annual lease payments of \$2M/yr plus an additional contingent rent of 2% of gross revenue per year
- Company's incremental borrowing rate is 8%
- No purchase option or residual value guarantee

# Contingent Rent Example

	Constant revenue	2% Revenue growth per year	5% Revenue growth per year	2% Revenue decline per year	Total
Sales over 15 years \$10M in year one	\$150,000,000	\$172,934,169	\$215,785,636	\$130,715,449	
Contingent rent 2%	\$3,000,000	\$3,458,683	\$4,315,713	\$2,614,309	
Present value	\$1,711,896	\$1,919,088	\$2,297,568	\$1,534,344	
Probability	25%	40%	25%	10%	
	\$427,974	\$767,635	\$574,391	\$153,434	\$1,923,434



# DISCLOSURES AND TRANSITION



# Disclosures in Financial Statements

- Nature of lease contracts
- Nature and amount of significant subleases
- Information about short term leases
- Maturity analyses
- Significant assumptions and judgments (including discount rate)
- Lessee must reconcile right of use assets and lease liabilities
- Lessor – significant risks and reconcile lease payment receivable, lease liabilities and residual values



# Transition

- Retrospective application
  - Must apply to all outstanding leases when standard goes into effect
  - Record present value of all remaining leases payments
  - Must go back to earliest period presented in financial statements



# TIME FRAMES



# Time Frames

- Comments are due December 15<sup>th</sup>
- Round tables – January, 2011
- Final standard – Target June, 2011
- Implementation - ?????

# Summary of Proposed Changes to the Financial Statements

## Lessee Accounting

	US GAAP – Operating Lease	US GAAP – Capital Lease	Exposure Draft – Right-of-Use Model
Balance Sheet		<ul style="list-style-type: none"> <li>• Asset (PP&amp;E)</li> <li>• Liability to make lease payments</li> </ul>	<ul style="list-style-type: none"> <li>• Right-of-use asset</li> <li>• Liability to make lease payments</li> </ul>
Income Statement	<ul style="list-style-type: none"> <li>• Rental Expense</li> </ul>	<ul style="list-style-type: none"> <li>• Depreciation Expense</li> <li>• Interest Expense</li> </ul>	<ul style="list-style-type: none"> <li>• Amortization of right-of-use asset</li> <li>• Interest Expense</li> </ul>
Statement of Cash Flows	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Financing Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Financing Activity</li> </ul>

# Summary of Proposed Changes to the Financial Statements

## Lessor Accounting

	US GAAP – Operating Lease	US GAAP – Direct Finance Lease	US GAAP – Sales-Type Lease	Exposure Draft - Performance Obligation Model	Exposure Draft - Derecognition Model
Balance Sheet		<b>Recognize:</b> <ul style="list-style-type: none"> <li>• Net investment in lease (receivable)</li> </ul> <b>Derecognize:</b> <ul style="list-style-type: none"> <li>• Underlying Asset</li> </ul>	<b>Recognize:</b> <ul style="list-style-type: none"> <li>• Net investment in lease (receivable)</li> </ul> <b>Derecognize:</b> <ul style="list-style-type: none"> <li>• Underlying Asset</li> </ul>	<ul style="list-style-type: none"> <li>• Right to receive lease payments</li> <li>• Lease liability</li> </ul>	<b>Recognize:</b> <ul style="list-style-type: none"> <li>• Right to receive lease payments</li> <li>• Residual Asset</li> </ul> <b>Derecognize:</b> <ul style="list-style-type: none"> <li>• Underlying Asset</li> </ul>
Income Statement	<ul style="list-style-type: none"> <li>• Rental Income</li> <li>• Depreciation Expense</li> </ul>	<ul style="list-style-type: none"> <li>• Interest Income</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue / Income</li> <li>• Cost of Sales</li> <li>• Interest Income</li> </ul>	<ul style="list-style-type: none"> <li>• Lease Income</li> <li>• Depreciation expense</li> <li>• Interest Income</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue / Income</li> <li>• Cost of Sales</li> <li>• Interest Income</li> </ul>
Statement of Cash Flows	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>	<ul style="list-style-type: none"> <li>• Operating Activity</li> </ul>



# Questions?

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